IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF TENNESSEE

In re LEROY M. HULL, III, Debtor.	No. 01-22897 Chapter 7
KUBOTA TRACTOR CORPORATION, Plaintiff, vs. LEROY M. HULL, III, Defendant.	Adv. Pro. No. 01-2065

M E M O R A N D U M

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MARCIA PHILLIPS PARSONS
UNITED STATES BANKRUPTCY JUDGE

In this adversary proceeding, the plaintiff, Kubota Tractor Corporation ("Kubota"), seeks a judgment against the debtor and a determination of nondischargeability pursuant to 11 U.S.C. § 523(a)(2), (a)(4), and (a)(6) for fraud, embezzlement, and willful and malicious injury, respectively. The alleged obligation arises from a "sale out of trust" of 53 tractors and implements floor-planned by Kubota to the debtor's wholly-owned corporation. For the reasons discussed hereafter, the court concludes that Kubota is entitled to a nondischargeable judgment against the debtor in the amount of $350,000. This is a core proceeding. *See* 28 U.S.C. § 157(b)(2)(I). This opinion contains findings of fact and conclusions of law pursuant to Federal Rule of Bankruptcy Procedure 7052.

I.

According to the parties' joint pretrial stipulations, the Leroy M. Hull Company, Inc. ("Hull Company") is a Virginia corporation with its principal business location at 1202 W. State Street, Bristol, Virginia. In 1979, Hull Company became a Kubota tractor dealer pursuant to a dealership agreement signed on its behalf by the debtor, Leroy M. Hull, III, who was vice-president at the time. The Kubota tractors and implements sold by Hull Company as a Kubota retail dealer were purchased

from Kubota on a floor-plan basis, with payment terms being dictated by the Kubota Terms and Discount Schedule ("Discount Schedule") in effect at the time of purchase. The Hull Company remained a Kubota dealer until April 2001 when its dealership was terminated by Kubota.

On August 21, 2001, the debtor filed for chapter 7 relief in this court. Ten days later on August 31, 2001, Hull Company filed for bankruptcy relief under chapter 11 in the Western District of Virginia, with the case subsequently converting to chapter 7. Kubota commenced the instant adversary proceeding on November 16, 2001, seeking a nondischargeable judgment against the debtor pursuant to 11 U.S.C. § 523(a)(6) "for Mr. Hull's willful and malicious conversion of plaintiff's floor-planned collateral." Kubota also contends that the debtor's acts and omissions constitute embezzlement and larceny, which are nondischargeable under § 523(a)(4) of the Bankruptcy Code, and actual fraud, nondischargeable under § 523(a)(2).

In response, the debtor denies that he has any personal liability to Kubota for any actions of Hull Company. He also denies that either he or Hull Company had the requisite willful and malicious intent to cause injury to Kubota since Hull Company used the proceeds from the sale of Kubota's collateral to pay its ordinary business expenses. With respect to the

allegations of embezzlement, larceny, and fraud, the debtor similarly contends that he lacked the requisite fraudulent intent. Lastly, the debtor asserts that Kubota contributed to its own losses by failing to investigate the financial condition of Hull Company on a regular basis, by failing to adequately conduct and/or investigate inventory audits, and by acquiescing in the manner in which the parties had done business over the years.

At the trial held in this adversary proceeding on October 9 and 10, 2002, the parties stipulated that in the event the court concludes the debtor is liable to Kubota, the amount of the judgment should be fixed at $350,000. The parties have also stipulated that during the years 1999-2001, Hull Company sold to its retail customers certain mowers and tractors it had obtained from Kubota on a floor-plan basis and received payments from customers, but failed to pay Kubota the wholesale balance owed to it. With respect to the debtor, the parties have stipulated that "[a]t all times material to this lawsuit, Leroy M. Hull, III was the President, director and sole stockholder of the Hull Company." More specifically, "[d]uring the years 1999-April 2001, Leroy M. Hull, III was the person primarily responsible for overseeing, directing and handling the day-to-day affairs of

the Hull Company, including the decisions when and how to pay bills or debts owed by the Hull Company."

II.

Before addressing the issue of nondischargeability, the court will first examine the debtor's assertion that he can not be personally liable for any alleged acts of conversion or fraud by his corporation, Hull Company. As succinctly expressed by a bankruptcy court earlier this year:

> Although officers and directors of a corporation generally are not liable for the debts of the corporation, they are personally liable to the extent that their participation in the commission of a tortious act results in harm to a third party. This principle is applicable in the bankruptcy context where an individual debtor, as an officer of a corporation, actively participates in the improper disposition or conversion of property that is subject to the security interest of a third party. (Citation omitted.) In such a situation, the individual debtor becomes personally liable to the secured creditor and the debt resulting from such liability is nondischargeable. (Citations omitted.) The critical factor in determining the corporate officer's personal liability and the dischargeability of the officer's obligation is whether there was personal involvement by the officer in the improper disposition or conversion of the secured creditor's collateral. If personal involvement on the part of an officer is shown, and the officer's conduct is shown to involve a willful and malicious injury, then the resulting personal debt of the officer is nondischargeable under § 523(a)(6). (Citations omitted.)

Community Savings Bank, Inc. v. Rountree (In re Rountree), 2002 WL 832669, *7 (Bankr. M.D.N.C. May 1, 2002). *See also General Motors Acceptance Corp. v. Bates*, 954 F.2d 1081, 1085 (5th Cir. 1992)("It is well settled law that when corporate officers directly participate in or authorize the commission of a wrongful act, even if the act is done on behalf of the corporation, they may be personally liable."); *Mercantile v. Speers (In re Speers)*, 244 B.R. 142, 146 (Bankr. E.D. Ark. 2000)(and cases cited therein)("In the context of bankruptcy, an individual debtor who is an officer of a corporation and who actively participates in the conversion of property subject to the security interest of a third party becomes personally liable to the third party such that the debt is nondischargeable pursuant to 11 U.S.C. § 523(a)(6)."). Consequently, if the court concludes that the debtor actively participated in or authorized the commission of a wrongful act like fraud, embezzlement, and/or willful and malicious conversion on behalf of Hull Company as alleged by Kubota, the debtor may be held personally liable. The burden of proof which must be met by Kubota to establish nondischargeability under 11 U.S.C. § 523 (a)(2), (a)(4), and (a)(6) is a preponderance of the evidence. *See Grogan v. Garner*, 498 U.S. 279, 287 (1991).

III.

Because the primary focus of Kubota's complaint is that the debtor converted its collateral, the court will begin its analysis with an examination of § 523(a)(6) which excepts from discharge debts "for willful and malicious injury by the debtor to another entity or to the property of another entity." 11 U.S.C. § 523(a)(6). *See ABF, Inc. v. Russell (In re Russell)*, 262 B.R. 449, 453 (Bankr. N.D. Ind. 2001) ("Historically, issues concerning dischargeability as a result of a debtor's conversion of collateral have been litigated under this section."). "From the plain language of the statute, the [debt] must be for an injury that is both willful and malicious. The absence of one creates a dischargeable debt." *Markowitz v. Campbell*, 190 F.3d 455, 463 (6th Cir. 1999).

With respect to the willfulness requirement, the United States Supreme Court noted in *Kawaauhau v. Geiger* that because the word "willful" in § 523(a)(6) modifies the word "injury," "nondischargeability takes a deliberate or intentional injury, not merely a deliberate or intentional act that leads to injury." *Kawaauhau v. Geiger*, 523 U.S. 57, 61 (1998). "Negligent or reckless acts ... do not suffice." *Id*. at 64. The Sixth Circuit Court of Appeals has interpreted *Geiger* to mean "that unless 'the actor desires to cause consequences of

his act, or believes that the consequences are substantially certain to result from it,' ... he has not committed a 'willful and malicious injury' as defined under § 523(a)(6)." *Markowitz*, 190 F.3d at 464.

The second component of § 523(a)(6), that the injury not only be willful, but also malicious, "means in conscious disregard of one's duties or without just cause or excuse; it does not require ill-will or specific intent to do harm." *Wheeler v. Laudani*, 783 F.2d 610, 615 (6th Cir. 1986). As stated by one court, "[t]here must ... be a consciousness of wrongdoing.... It is this knowledge of wrongdoing, not the wrongfulness of the debtor's actions, that is the key to malicious under § 523(a)(6)." *In re Russell*, 262 B.R. at 455. With these standards in mind, the court will review the evidence presented at trial in order to determine whether the debtor willfully and maliciously injured Kubota or its property.

As previously noted, Hull Company purchased tractors and implements from Kubota for resale on a floor-plan basis. The dealer agreement between Kubota and Hull Company granted Kubota a security interest in all products purchased by Hull Company from Kubota and their proceeds. According to the Discount Schedule, the invoice for each item purchased by Hull Company from Kubota would have a due date printed on it. The unpaid

invoice amount was "immediately due and payable on or before the earlier of (i) the date of sale, or (ii) the Due Date." With respect to tractors, the due date was typically the 25th day of the ninth month following shipment; smaller pieces of equipment had a due date six months following shipment. If a tractor or piece of equipment had not been sold by its due date, the dealer could defer full payment of the invoice amount by making a curtailment payment of 10% of the original invoice amount and commencing monthly interest payments of prime plus 1% on the unpaid balance. Each curtailment payment would defer full payment for six months and a dealer could make a maximum of three curtailment payments. At the end of the third curtailment period (i.e., 18 months after the curtailment payments began and 27 months from the date of shipment with respect to tractors), final and full payment was due.

The evidence presented by Kubota indicated that dealers were mailed each month a dealer machine statement listing by invoice, model, and serial number each piece of equipment sold to the dealer for which Kubota had not been paid in full. The statement listed the invoice date, the due date, the original price, any curtailment payments, the ending balance, and any accrued interest. In addition to purchasing equipment from Kubota on a floor-plan basis, a dealer could also purchase parts

and supplies from Kubota on an open account with payment due within thirty days. Each month a dealer would receive, in addition to the dealer machine statement, an open account statement listing amounts owing on these parts purchases, floor-plan interest, and insurance if the dealer had purchased insurance through Kubota.

Periodically, Kubota would audit the floor-plan inventory of each dealer, either by a Kubota regional sales manager or an outside independent agency, in order to compare Kubota's records of the dealer's unsold and unpaid inventory with the dealer's on-site inventory. If the on-site inspection revealed that certain items of inventory were missing, the auditor proceeded to question the dealer regarding the location of the missing inventory. Acceptable explanations for missing inventory were that the item was out on demonstration to a potential customer or county fair, etc., or had been sold and the dealer was awaiting payment from the customer. Gary Caldwell, the former southeast finance manager for Kubota, testified that Kubota relies heavily upon its dealers to correctly and honestly identify the location or disposition of inventory not on the dealer's lot.

One such audit was conducted at Hull Company on October 30, 2000, by Eric Hall, an employee of Deutsche Financial Services.

Mr. Hall testified that prior to the audit Kubota provided him a preliminary inspection checklist which listed 91 items of inventory sold to Hull Company for which Kubota had not been paid. With this checklist, Mr. Hall then went to the Hull Company and compared the serial numbers on the list with the inventory on hand. Based on his inspection, Mr. Hall determined that numerous items of inventory were not on site. He testified that he then went over the list with the debtor who personally set forth on the checklist the location of the missing equipment. According to the information provided by the debtor, 22 items were being demonstrated at various specified locations, seven had been sold to named individuals and Hull Company was "awaiting settlement," and three had been recently sold and the check was on its way to Kubota. The debtor then signed the report and Mr. Hall forwarded it to Kubota.

Similarly, Kubota arranged another audit at Hull Company on January 18, 2001, with this one having been conducted by Stephanie Mougianis of Deutsche Financial. As Mr. Hall had done, Ms. Mougianis obtained a preliminary inspection checklist from Kubota, compared it to the inventory on site and then discussed the missing items with the debtor. Ms. Mougianis wrote down the debtor's explanations and then he signed the report. As with respect to Mr. Hall, the debtor related that

numerous tractors were out on demo, and that some other items had been sold and he was awaiting payment from the customer.

All of the Kubota personnel who testified stated that prior to 2000, Hull Company had been a good dealer; it had always paid its bills promptly and never had any past-due conditions. In June or July 2000, however, Hull Company became delinquent in its curtailments and became slow in paying its open account. The company was placed on COD basis in August and several phone conversations ensued between Mr. Caldwell and the debtor regarding the delinquency. Hull Company apparently became current but was subsequently placed on COD basis again in March of 2001. By letter dated March 23, 2001, Mr. Caldwell informed Hull Company that it was in default as $17,103.21 was past due on the open account statement and $420,446.42 was past due on the dealer machine statement, and that unless these defaults were cured by April 8, 2001, the dealer agreement would be terminated.

In order to talk to the debtor about Hull Company catching up its arrearage, Phil Owens, the Kubota regional sales manager, and John Wright, the credit manager for Kubota, traveled to Hull Company's location in early April 2001. According to Mr. Owens, at this meeting the debtor blurted out that he had been lying to them, that he had been selling tractors out of trust

and was sorry, and that he had no money to pay them. Messrs. Owens and Wright immediately reported the debtor's statements to their superiors at Kubota, prompting Mr. Caldwell and Rick McPeak, the Kubota district sales manager, to drive to Bristol on April 19, 2001, to meet with the debtor. According to Mr. Caldwell, the debtor informed them at that time that "a lot of the inventory had been sold months ago, and that he had received his money, and he had not paid us." Mr. Caldwell testified that when he asked what had happened to the money, the debtor responded that "he had been out of trust for a long time," and "that most of his money had gone to pay curtailments and floor plan interest." Mr. Caldwell also testified that the debtor stated that he was going to try to borrow money from the bank to pay Kubota, but did not think the bank would loan him any more. Mr. Caldwell stated that in light of the situation, the Kubota personnel began an audit and commenced removal of the remaining Kubota inventory from the dealership. Mr. Caldwell's testimony was corroborated by that of Mr. McPeak.

When Mr. Caldwell returned to his office on April 27, 2001, he wrote a memo to the file describing the events that had transpired concerning Hull Company. The memo reflects that before Mr. Caldwell left Bristol, he again met with the debtor and they reviewed what had happened to cause the sales out of

trust. The memo reflects that the debtor "again stated that it had been going on for some time and that he had been lying to Phil Owens about the disposition of the inventory. He said that he really felt sorry about that but once it started, it got out of control and there was nothing he could do. He stated that he is relieved that it is out in the open now." Subsequently by certified letter dated May 15, 2001, Mr. Caldwell formally canceled the dealer agreement between Kubota and Hull Company.

Kubota's audit and a subsequent examination of Hull Company's books and records revealed that 53 tractors and other pieces of equipment had been sold by Hull Company without the sale proceeds having been forwarded to Kubota. Many of these items had been sold and the proceeds received by Hull Company prior to the October 2000 and January 2001 audits conducted by Mr. Hall and Ms. Mougianis respectively. Thus, these items had been included in the lists of missing inventory prepared by these auditors for which the debtor was asked for an explanation as to why they were missing. According to Hull Company's records, the debtor gave incorrect information on 21 items to Mr. Hall and on 22 items to Ms. Mougianis, falsely stating that the missing items were out on demo at a specified location or sold but awaiting payment when in fact the equipment had been sold, often many months before, and Hull Company had been paid

in full. For example, Hull Company records reflected that item no. 1, a 1975 Ford 4000 tractor had been sold to Pete Nininger on May 10, 2000, prior to its due date of July 25, 2000, and that Hull Company was paid on June 25, 2000. Yet the debtor advised Ms. Mougianis in January 2001 that the tractor went out on demo to Junior Gwinn in October and would be back in February. Item no. 3 was shipped to Hull Company on March 31, 2000, with a due date of December 25, 2000. Although Hull Company sold and was paid in full for this equipment on September 28, 2000, the debtor advised both Mr. Hall and Ms. Mougianis that Hull Company was awaiting payment from the customer. With regard to item no. 20, the debtor advised Mr. Hall in October 2000 that the equipment was out on demo to Don's Landscaping, yet it had actually been sold to Heritage Funeral Service on June 11, 1999.

In addition to the testimony referenced above, Phil Owens testified that as regional sales manager for this area, he had called on the debtor on behalf of Kubota for 18 years, that prior to these revelations coming to light, he had a very favorable impression of the debtor and Hull Company, and trusted the debtor both as a person and a dealer. He testified that he never knew and the debtor never told him prior to April 2001 that he was retaining rather than forwarding the sale proceeds

to Kubota. Mr. Owens testified that when performing audits he always accepted the debtor's word as to the location of the missing inventory, that he knew there were a number of units that had been sold for which Kubota had not been paid, but the debtor advised him that he was awaiting payment from the customer which is an acceptable delay. Mr. Owens also stated that the debtor complained about interest and curtailment payments, but that when he offered to take some inventory away so it could be sold by another dealer, the debtor always refused. Mr. Owens testified that during his 21 years in the business, he had only had one dealer, other than the debtor, who had sold out of trust and that incident only involved two tractors. He testified that he had considered the debtor to be a friend and felt betrayed by the debtor's deception. Mr. Owens resigned from Kubota a month after the sales out of trust were discovered; he stated that he had been planning to retire anyway but the events involving Hull Company sped up his retirement about six months because his heart was not in his work anymore.

According to the debtor, Hull Company began experiencing financial problems when Kubota imposed a maximum of three curtailments on floor-planned items in 1998. He stated that prior to then a dealer could curtail items forever and that because some of his inventory was five or six years old and

totaled up to a million dollars, he had a lot of inventory for which to pay. The debtor also stated that the interest on curtailed items was originally 5%, that it subsequently increased to 8 or 9% and if an account became past due, the interest rate became 11 or 12%. According to the debtor, because of Kubota's changes and its resulting impact on Hull Company's finances, Hull Company borrowed monies in 1997, 1999, and 2000 totaling $350,000.

The debtor denied that there was any requirement to remit the sale proceeds to Kubota upon the resale by Hull Company of a Kubota floor-planned piece of equipment. He testified that instead, a dealer was simply required to commence curtailment payments when the due date arrived. In his deposition, when asked if it was his responsibility to turn over proceeds from the sale of inventory once he got the money, the debtor responded that "I was supposed to pay them for it when I was ready to. That's the way we always did business." And, when asked how did he decide when he was "ready" to pay Kubota, the debtor stated that there was no "hard and fast rule," that it was after he had been paid, had determined that his customers were satisfied with their purchase, and just based on his "30 years of doing it." At another point in his deposition, the debtor explained "there wasn't any understanding or anything as

far as there was no definite time to send it in or anything like that."

The debtor testified that when he sold a piece of equipment he would simply deposit the proceeds into the company bank account and use them to pay for the oldest inventory. However, on cross-examination, evidence was introduced which indicated that on at least two specific occasions in 2000, Hull Company sold a piece of inventory and within days reported the sale to Kubota and remitted the proceeds even though the due date on the equipment had not yet arrived.

With respect to the periodic audits conducted by Kubota or on its behalf, the debtor testified that they were never emphasized by Kubota. As explained by the debtor, "they were no big deal; I never attempted to conceal or hide any information — I was going to pay them all along — so it didn't really matter." The debtor admitted that it was his responsibility to give the auditors correct information, but also stated at one point that it didn't really matter what he told the auditors — they just needed to write something down.

With respect to the audits conducted by Phil Owens, the debtor testified that Phil Owens would come in and do the inspection and then come inside and say "let's go to lunch." Thereafter, Phil Owens would write down what inventory was

missing and the debtor would try to find them. The debtor testified that sometimes when he could not figure out where a piece of missing inventory was located, Mr. Owens would write down that it was there even though it was not. As explained by the debtor, "you know, if it wasn't on the yard and I couldn't figure out where it was, and I was busy and he was in a hurry to get to the next stop, he'd just put down that it was there and go on. I mean, it didn't really matter. We were going to pay for it anyway. What difference does it make?"

The debtor also testified at trial that he told Phil Owens on several occasions that he had been taking proceeds from the sale of tractors and using it to pay curtailments and interest. Similarly, in his deposition, the debtor testified that he told Phil Owens that he was "paying for curtailments and interest on stuff that I should be paying for," but at another point in his deposition, when asked if prior to April 2001 he ever told people from Kubota that he had sold equipment, received the money, but had not sent the money in, the debtor responded "no, no."

With respect to the visit by Phil Owens and Rick McPeak in April 2001, the debtor testified that he told them that he couldn't pay $4,500 or $5,000 a month in interest payments anymore and that "it is over – I've paid you all I can." The

debtor also testified that he "guess" he told Phil Owens that he had lied to him and when asked to what he was referring when he made this statement, answered "I don't know, I just couldn't pay him any more money." In his deposition, the debtor testified that he could not recall what had been said during the visit: "I don't recollect anything. It was crazy in there. I was – it was wild."

The debtor testified that he drew an annual salary of $22,000 from Hull Company and then took additional monies at the end of the year if Hull Company had a profit which it always did until the year 2000. The debtor and his wife's bank statements indicate that they had deposits totaling $132,000 into their checking account in 2000. Mr. Hull explained that $6,000 of this was rental income, $20,000 were proceeds from a home equity loan which he used to put a new roof on his house, and $35,000 was an inheritance from his mother. The evidence indicated that the debtor and his wife had two sons in college at Virginia Military Institute for which they made tuition payments totaling $8,000 in August 2000. Other personal cash outlays of over $17,000 were made by the Hulls in October through December 2000 in connection with a car wash they were building near their home. The last evidence presented was the testimonies of character witnesses for the debtor who indicated that he had an

excellent reputation in the community and was well thought of, a family man and a church-going man.

Based on all of the evidence, it is clear that there was an injury to Kubota in the nature of the conversion of proceeds from the sale of its collateral. The critical inquiry of course is whether the conversion was willful and malicious within the meaning of § 523(a)(6). Utilizing the standards for these terms espoused by the Sixth Circuit Court of Appeals in *Markowitz*, *see* 190 F.3d at 464; and other Sixth Circuit authority cited above, Kubota contends that the debtor "knowingly, intentionally and without just cause or excuse failed to report the sales and failed to remit the sales proceeds to Kubota and that he did so over many months whereby he knew or was substantially certain that he could never repay Kubota's growing debt and that Kubota's rights in the collateral and to the proceeds thereof would be lost." The debtor's response is that any conversion was not willful or malicious because he never intended to injure Kubota; he simply did business in accordance with the parties' normal business practice; the proceeds from the sale of inventory were utilized for business purposes and he never personally profited; and he always intended to repay Kubota.

There is some support for the debtor's assertion that absent a subjective intent to injure, the debt is dischargeable. At

least three courts have concluded that "if the debtor's unauthorized retention and use of proceeds was done in order to save the debtor's business and was not intended to injure the creditor, the court [may] find no willful injury even though the debtor was aware of the creditor's security interest in the proceeds and that such use by the debtor was not authorized." *See In re Rountree*, 2002 WL 832669, *6 (citing *Mayfield Grain Co. v. Crump (In re Crump)*, 247 B.R. 1 (Bankr. W.D. Ky. 2000); *Nat'l City Bank, Northwest v. Wikel re Wikel)*, 229 B.R. 6 (Bankr. N.D. Ohio 1998); *Fla. Outdoor Equip., Inc. v. Tomlinson (In re Tomlinson)*, 220 B.R. 134 (Bankr. M.D. Fla. 1998)).

This court is not persuaded that either *Geiger* or *Markowitz* mandate such a result. Indeed, the United States Supreme Court specifically addressed the tort of conversion in *Kawaauhau v. Geiger,* observing that its construction of § 523(a)(6) as being limited to the traditional intentional tort was in accord with its holdings in *McIntyre v. Kavanaugh*, 242 U.S. 138 (1916) and *Davis v. Aetna Acceptance Co.*, 293 U.S. 328 (1934), both of which were conversion cases. *Geiger*, 523 U.S. at 63. The court noted that it had held in *McIntyre* that a broker who "'deprived another of his property forever by deliberately disposing of it without semblance of authority'" had committed "an intentional

injury to property of another, bringing it within the discharge exception." *Id.* (quoting *McIntyre*, 242 U.S. at 141). The *Geiger* court also observed that in *Davis*, it had explained that "not every tort judgment for conversion is exempt from discharge. Negligent or reckless acts ... do not suffice." *Id.* at 64 (citing *Davis*, 293 U.S. at 332). As noted by the bankruptcy court in *In re Russell*, "[*Geiger*] held only that § 523(a)(6) required an intentional injury rather than an intentional act.... This standard may be satisfied with something less than a showing that the debtor's actions were motivated by a specific desire to harm the creditor or its collateral." *In re Russell*, 262 B.R. at 454.

In its post-*Geiger* analysis, the Ninth Circuit Court of Appeals considered § 523(a)(6) in the context of an employer who had withheld wages from an employee even though the employer possessed the funds to pay. *See Petralia v. Jercich (In re Jercich)*, 238 F.3d 1202 (9th Cir. 2001). The debtor/employer argued that in order for the debt to be nondischargeable, he must have withheld the wages with the specific intent of harming the employee. *Id.* at 1207. The court of appeals disagreed, citing the *Geiger* court's discussion of *McIntyre*, wherein, according to the Ninth Circuit, "the Court indicated that a

wrongful act that is voluntarily committed with knowledge that the act is wrongful and will necessarily cause injury meets the 'willful and malicious' standard of § 523(a)(6)." *Id.* at 1208. The *Jercich* court stated that this language was consistent with its *In re Bailey* ruling that "the conversion of another's property without his knowledge or consent, done intentionally and without justification and excuse, to the other's injury, constitutes a willful and malicious injury within the meaning of § 523(a)(6)." *Id.* The Ninth Circuit found this approach to be consistent with the Sixth Circuit's *Markowitz* criteria that the debtor either subjectively intended to inflict injury or believed that injury was substantially certain to occur as result of his conduct. *Id*.[1]

Other courts have reached similar conclusions. For example, in *In re Rountree*, the court observed that "[a] deliberate and

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[1]In a footnote, the Ninth Circuit Court of Appeals stated that:

> [I]mposing a specific intent requirement as urged by [the debtor] would produce absurd results that could not possibly have been intended by Congress. For example, if a showing of specific intent were required, a debtor could sell, without consequence, collateral subject to a security agreement with the knowledge that such an act violates the security agreement as long as the debtor did not have the specific intent to injure the creditor but instead had the specific intent to get the money for the debtor's own use.

In re Jercich, 238 F.3d at 1208 n.35.

intentional disposition of a creditor's collateral or proceeds that is known by the debtor to be unauthorized and contrary to the security agreement ... is substantially certain to cause injury to the creditor or its security interest." *In re Rountree*, 2002 WL 832669, *7 n.7. Applying analogous language, the bankruptcy court in *In re Jones* held that a creditor may satisfy the *Markowitz* standard for "willful" by "demonstrating the existence of two facts: (1) the debtor knew of the creditor's lien rights; and (2) the debtor knew that his conduct would cause injury to those rights." *J&A Brelage, Inc. v. Jones (In re Jones)*, 276 B.R. 797, 802 (Bankr. N.D. Ohio 2001)(citing *Mitsubishi Motors Credit of Am., Inc. v. Longley (In re Longley*), 235 B.R. 651, 657 (B.A.P. 10th Cir. 1999); *Call Fed. Credit Union v. Sweeney (In re Sweeney)*, 264 B.R. 866, 872 (Bankr. W.D. Ky. 2001)). *See also In re Russell*, 262 B.R. at 455 ("[T]he proper question is not whether the debtor intended that its secured creditor would go unpaid. Instead, the question to ask is whether the debtor intended to improperly use the creditor's collateral and/or its proceeds for purposes other than the payment of the debt that property secured. If so, there is an intentional injury.").

This court finds that the evidence presented in this case clearly establishes that the debtor willfully converted the proceeds from the sale of Kubota's collateral. Although the debtor denied that he knew of Kubota's lien, he simply was not credible in this and with respect to most of his testimony. His answers to questions both at trial and in his deposition were evasive and often nonresponsive. The debtor through his company had been a Kubota dealer for 22 years; he was also a dealer for Snapper, Bush Hog, and E.J. Smith, a distributor of lawn and garden equipment, and all of these companies floor-planned their products just like Kubota. As an experienced business man, the debtor clearly understood the concept of floor-planning and how it worked, even placing trade-ins from customers on Kubota's floor-plan.

The debtor also knew, despite his representations to the contrary, that he was required to immediately remit the proceeds from a sale of inventory to Kubota. The dealer terms and conditions mandated the purchase price to be "immediately due and payable" on the "date of sale" if the sale occurred before the "Due Date." All three present or former Kubota representatives who testified unequivocally that payment was due at time of sale. The debtor admitted that this was the requirement with respect to Snapper and E.J. Smith, and their

representatives testified that this was the standard in the industry. The debtor knew that Kubota conducted audits and that the purpose of the audits was to account for the inventory. The debtor's testimony that there was no definite time to send in payment to Kubota and that he could send it in whenever he was ready was simply too ludicrous to even consider.

The debtor's knowledge of Kubota's security interest, the requirement that sale proceeds be immediately remitted, and that his intentional withholding of these proceeds was wrongful was plainly evident from his confessions to Phil Owens, Gary Caldwell, Rick McPeak, and John Wright that he had been selling out of trust for some time, that he had been lying to them, and that he was sorry. These gentlemen's accounts of the debtor's revelations of wrongdoing were corroborated by the memorandum Mr. Caldwell wrote shortly after the conversations occurred. These men were highly credible and it was clear that all, especially Mr. Owens, had not only been surprised, but also very upset over the debtor's actions.

Further evidence of the fact that the debtor intentionally and deliberately converted Kubota's proceeds with full knowledge that these actions were not authorized by Kubota is the deception by the debtor in connection with the audits. If the debtor really believed that he was free to retain sale proceeds

and simply begin curtailment payments when the due dates arrived, he would have told the auditors that he had sold the inventory and retained the proceeds when they asked about missing inventory. Instead, he deliberated and intentionally misrepresented the status of numerous tractors and other pieces of equipment in order to conceal his sales out of trust, knowing that Kubota accepted him at his word because of their long-standing relationship and the trust Kubota placed in him.

Circumstantial evidence also establishes that the debtor was substantially certain that his actions would injure Kubota. *See In re Jones*, 276 B.R. at 802 (Since a debtor will usually not admit to causing an injury, the party seeking "to demonstrate that a debtor acted 'willfully' for purposes of § 523(a)(6), must normally establish this requirement indirectly through the utilization of circumstantial evidence."). Although the debtor testified that he always intended to pay Kubota, Hull Company lost in excess of $200,000 in the year 2000. By January 2000, the items sold out of trust totaled $63,310.94, more than the company's bank balance. This out-of-trust total continued to rise throughout 2000 and the first quarter of 2001 to $437,542.17, while Hull Company's bank account generally declined, there being only $22,350.05 in the account at the end of April 2001.

Lastly, all of this evidence cited above not only demonstrates the willfulness of the debtor's actions, but also their maliciousness. As previously noted, malicious indicates knowledge of wrongdoing rather than ill-will or specific intent to harm. *See In re Russell*, 262 B.R. at 455.

A case similar to the one at hand is *In re Rountree*, wherein Community Savings Bank extended a line of credit to Rountree Motorcars, Inc., the operator of a used car lot. *In re Rountree*, 2002 WL 832669, *1. The obligation was secured by a security interest in the vehicles on the lot. Under the terms of the parties' agreement, principal payments were to be made when vehicles were sold for the amounts that the bank had advanced on the particular vehicles. *Id*. Mr. Rountree, along with his wife, were the sole shareholders, officers and directors of the corporation, and Mr. Rountree ran the business on a day-to-day basis. *Id*. at *8. The business began to fall behind in paying the bank and subsequently commenced using the proceeds from current transactions to pay the bank for vehicles that had been sold earlier. When the business failed, the bank learned that nine vehicles had been sold for which it had not been paid. *Id*. at *2.

Upon the Rountrees' personal bankruptcy filing, the bank sought a judgment for the value of the vehicles and a

determination of nondischargeability under § 523(a)(6). Utilizing the *Geiger* criteria and the general law cited above concerning individual liability of an officer, the court concluded that because of Mr. Rountree's personal involvement and control of the corporation, his knowledge of the bank's security interest in the automobiles and the obligation to remit the sale proceeds, and his knowingly, improper use of the proceeds for purposes other than payment of the secured debt, he was personally liable to the bank for the losses resulting from the failure to remit payments and the obligation constituted a willful and malicious injury to property within the meaning of § 523(a)(6). *Id.* at *7. *See also In re Russell*, 262 B.R. at 455-56 (Because the debtor's actions in selling soybeans and then using the sale proceeds for purposes other than payment of the obligation the crop secured were intentional and in conscious disregard of his duty, the debt was nondischargeable under § 523(a)(6) even though the debtor stated that he did not intend to harm the secured creditor and was only hoping to get through a financial crisis and repay all his creditors.).

In the present case, the parties have stipulated that during the time in question, the debtor was the "person primarily responsible for overseeing, directing and handling the day-to-day affairs of the Hull Company, including the decisions when

and how to pay bills or debts owed by the Hull Company." In light of this stipulation and this court's finding that the injury to Kubota was willful and malicious, the court concludes that Kubota is entitled to a personal judgment against the debtor and that the judgment is nondischargeable under § 523(a)(6).

Kubota also contends that the debtor's acts constitute embezzlement[2] under § 523(a)(4) which excepts from discharge any debt "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." The Sixth Circuit Court of Appeals has stated that:

> Federal law defines "embezzlement" under section 523(a(4) as "the fraudulent appropriation of property by a person to whom such property has been entrusted or into whose hands it has lawfully come." (Citation omitted.) A creditor proves embezzlement by showing that he entrusted his property to the debtor, the debtor appropriated the property for a use other than

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[2]In Kubota's complaint and in the parties' joint statement of issues, Kubota not only raises embezzlement under § 523(a)(4) but also larceny. Nonetheless, Kubota's brief does not address larceny as a basis for nondischargeability. Furthermore, the treatise COLLIER ON BANKRUPTCY indicates that "[embezzlement] differs from larceny in the fact that the original taking of the property was lawful, or with the consent of the owner, while in larceny the felonious intent must have existed at the time of the taking." 4 COLLIER ON BANKRUPTCY ¶ 523.10[2] (15th ed. rev. 2002). In the present case, the initial possession of the sale proceeds by the debtor through Hull Company was lawful and with Kubota's consent. Thus, to the extent nondischargeability exists under § 523(a)(4), it does so by way of embezzlement rather than larceny.

> that for which it was entrusted, and the circumstances indicate fraud.

Brady v. McAllister (In re Brady), 101 F.3d 1165, 1172-73 (6th Cir. 1996).

As the court previously noted above with respect to its § 523(a)(6) discussion, Kubota entrusted its collateral to the debtor, who rather than paying the sale proceeds over to Kubota as required, appropriated them for use in Hull Company. Furthermore, the circumstances indicated fraud as shown by the debtor's deception in lying to Kubota about the missing inventory. *Compare NesSmith v. Kelley (In re Kelley)*, 84 B.R. 225, 231 (Bankr. M.D. Fla. 1988) ("[T]he showing of fraudulent intent which is a prerequisite to a finding of embezzlement under Section 523(a)(4) may be negated by a showing that the defendant used such funds openly and without concealment.").

A similar fact pattern to the case at hand can be found in *Peavey Electronics Corp. v. Sinchak (In re Sinchak),* 109 B.R. 273 (Bankr. N.D. Ohio 1990). The debtor therein entered into a floor-plan financing agreement with a electronic musical instrument manufacturer. *Id.* at 274-75. As in the present case, when an item sold, the debtor was obligated to pay the creditor the outstanding balance. *Id.* at 275. If an item remained unsold for more than three months, the debtor was

required to pay the creditor 10% of the wholesale price each month the item remained unsold. *Id.* By switching inventory tags on some merchandise when the creditor made an inventory check, the debtor created the appearance that items which had actually been sold were still being held in inventory and thus avoid or delay paying the creditor when a balance was due. *Id.* Upon the debtor's bankruptcy filing, the creditor discovered that 75 items totaling $22,000 were missing from the debtor's inventory. These items had actually been sold by the debtor with their sale being concealed through the switching of tags. *Id*.

The bankruptcy court concluded that the debtor's obligation to the creditor for the balance owed on the missing instruments was nondischargeable as an embezzlement under § 523(a)(4) even though the debtor did not appear to have any criminal intent and had not used any of the proceeds for personal benefit. *Id*. at 276. The *Sinchak* court observed that the debtor was under an obligation to pay the sale proceeds to the creditor, and any use of the proceeds for a contrary purpose was beyond the debtor's scope of authority and without the consent of the creditor. *Id.* at 276-77. In addition, deceit was established by the debtor's changing of inventory tags which allowed him to use the sale proceeds for his own purposes. *Id*. at 277.

In support of his assertion that his actions did not constitute embezzlement, the debtor herein cites *In re Scarpello* wherein the bankruptcy court concluded that the debtor's misappropriation of funds she was holding for her cousin, while a breach of contract, did not constitute embezzlement. *Rae v. Scarpello (In re Scarpello)*, 272 B.R. 691, 703 (Bankr. N.D. Ill. 2002). The court based this conclusion on the debtor's lack of the requisite fraudulent intent, citing the debtor's testimony that at all times she intended to repay her cousin. *Id*.

In the present case, however, as in the *Sinchak* case, deceit and fraudulent intent were established by the debtor's deliberate misrepresentations as to the location and status of the missing inventory. Furthermore, "[t]hat the debtor may have intended only temporarily rather than permanently to deprive the owner of his or her funds does not eliminate the inference of intent to deprive the owner of the funds within the meaning of 11 U.S.C.A. § 523(a)(4)." John P. Ludington, Annotation, *Bankruptcy: What Constitutes Embezzlement of Funds Giving Rise to Nondischargeable Debt under 11 U.S.C.A. § 523(a)(4)*, 99 A.L.R. FED. 124, § 12(d) (1990). *See also Gribble v. Carlton (In re Carlton)*, 26 B.R. 202, 205 (Bankr. M.D. Tenn. 1982)("The legislative history of § 523(a)(4) reveals that the terms embezzlement and larceny were intended to make non-dischargeable

any debt resulting from a conversion in which the debtor wilfully and maliciously intended to borrow property for a short period of time with no intent to inflict injury but on which injury was in fact inflicted.").

The debtor's argument based on lack of personal benefit from the embezzlement is equally without merit. In the Sixth Circuit Court of Appeals' *Brady* decision, the court observed that regardless of the fact that the debtor placed money into a corporation controlled by him rather than into his own account, "he disregarded [the] creditor's wishes concerning the proper disbursal of the funds and instead used the money to improve the finances of a corporation which he controlled and of which he was the president. We therefore reject the implication by debtor that the 'appropriation' requirement for embezzlement under section 523(a)(4) demands a showing that the debtor individually profited in an amount equal to that lost by the creditor." *In re Brady*, 101 F.3d at 1173.

In addition to claims of nondischargeability under § 523(a)(6) and (4), Kubota also raised in its complaint an allegation of fraud under § 523(a)(2). Nonetheless, Kubota did not brief this issue in its trial memorandum other than to state that "Mr. Hull's aforesaid acts and omissions amount to actual fraud and false representations." In light of this failure, the

court deems a nondischargeability determination under § 523(a)(2) to have been waived.

IV.

In accordance with the foregoing, the court will, contemporaneously with the filing of this memorandum opinion, enter an order awarding Kubota a judgment against the debtor Leroy M. Hull, III in the amount of $350,000. The order will also provide that the judgment is nondischargeable under 11 U.S.C. § 523(a)(4) and (6).

FILED: December 13, 2002

BY THE COURT

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MARCIA PHILLIPS PARSONS
UNITED STATES BANKRUPTCY JUDGE